Michael S. Johnson (#6903)
Christopher Shiraldi (#13355)
Special Assistant Attorneys General
Sean D. Reyes (#7969)
UTAH ATTORNEY GENERAL
675 East 500 South, Suite 500
Salt Lake City, Utah 84102
Telephone: (801) 538-5100
mjohnson@utah.gov
cshiraldi@utah.gov

Attorneys for Respondent Utah School and Institutional Trust Lands Administration

UTAH SCHOOL AND INSTITUTIONAL TRUST LANDS ADMINISTRATION BOARD OF TRUSTEES

EOG RESOURCES, INC., Petitioner, v. UTAH SCHOOL AND INSTITUTIONAL TRUST LANDS ADMINISTRATION, OFFICE OF THE DIRECTOR, Respondent.	**RESPONSE OF THE UTAH SCHOOL AND INSTITUTIONAL TRUST LANDS ADMINISTRATION TO EOG RESOURCES, INC.'S PETITION FOR REVIEW**

Respondent Utah School and Institutional Trust Lands Administration ("SITLA") respectfully submits this response to Petitioner EOG Resources, Inc.'s, ("EOG's") Petition for Review (the "Petition") dated August 22, 2018.

POSTURE OF THE CASE AND THE SCOPE OF THIS RESPONSE

Pursuant to the stipulated motion of the parties, the Board has elected to hear this appeal as a formal adjudication and appoint a hearing examiner to take evidence and make recommended findings of fact and conclusions of law. At the Board's request, the parties are presently identifying hearing examiner candidates and will present this list to the Board prior to the November 15, 2018

Board meeting.

Although it is not required under the Board's rules to file a response to the petition, *see* Utah Admin. Code R850-8-1200.1, -1300.3 and -1600.1, SITLA sought leave to file a short response to help frame the dispute and apprise the Board of the legal and factual issues that will need to be resolved going forward. The scope of this response is limited to identifying these issues to help provide a roadmap for future proceedings. The specifics concerning these issues will be addressed in greater depth through the presentation of evidence, and further briefing and argument, once a hearing examiner is appointed and a schedule is established.

BACKGROUND CONCERNING
THE AUDIT UNDER REVIEW

This appeal arises out of a SITLA audit of royalties paid by EOG on a number of SITLA oil, gas and hydrocarbon leases in the Chapita and Stagecoach area in Uintah County, Utah.

The applicability of federal regulations.

A central feature of SITLA's audit procedures (and a primary question in dispute in this appeal) is the application of federal regulations promulgated by the Office of Natural Resources Revenue (ONRR). Section 4 of the majority of the oil and gas leases[1] at issue deals with the payment of royalties to SITLA. Section 4(b) of each lease states that where gas is sold under a contract,

> the reasonable market value of such gas for the purpose of determining royalties payable hereunder, shall be the price at which the production is sold, provided that in no event shall the price for gas be less than that received by the United States of America for its royalties from gas of like grade and quality from the same field.

[1] The subject of the Petition deals mainly with three oil and gas leases dated January 2nd, 1953. Two (2) of the oil and gas leases are to Continental Oil Company (Mineral Lease Nos. 3077 and 3078) and one (1) oil and gas lease is to Shell Oil Company (Mineral Lease No. 3355). Section 4, entitled ROYALTIES, is the same in all three oil and gas leases. The Petition only addresses the lease language contained in these oil and gas leases; accordingly, this response only addresses these oil and gas leases as well.

Because SITLA's lease form establishes as a floor the price the federal government receives under its regulations for royalty valuation purposes, it has been the consistent practice of SITLA for decades to require its lessees to pay royalties on the same basis as lessees of federal lands. This involves the "unbundling" of certain costs incurred in placing gas into a marketable condition (which are not deductible from royalties) from deductible transportation and processing costs.

The 2012 Audit Report.

SITLA initially informed EOG via a February 14, 2012 letter that it was commencing an audit of the 2007 through 2011 calendar years. The audit culminated in an Audit Report dated August 1, 2012 (the "2012 Report") (attached to the Petition as Exhibit B). Consistent with the terms of the applicable leases and the ONRR regulations, the 2012 Report analyzed the unbundling of marketable condition costs from transportation and processing costs. As of the date of the 2012 Report, no unbundling analysis of the field gathering and processing systems at issue had been performed by the federal government (which would provide a formula to directly apply to EOG's royalties), and EOG had not provided SITLA with any similar analysis of its own. As a consequence, SITLA utilized a reasonable analog unbundling analysis performed by the federal government on a gas system in New Mexico. This showed a balance of $820,120 of unpaid royalties owing to the Trust.

SITLA in the 2012 Report proposed to settle the audit with EOG by adhering to the methodology discussed above, and offered as an incentive to waive additional claims related to volumes of gas deducted by EOG for fuel use. Additionally, SITLA invited EOG to submit any evidence it possessed, including an unbundling methodology of its own, or to request a meeting with SITLA staff to work through the audit issues.

EOG's apparent agreement with the 2012 Report findings.

In August of 2012, following issuance of the 2012 Report, EOG indicated to SITLA that it intended to recalculate its SITLA royalties for the 2007 through 2011 calendar years utilizing an unbundling methodology consistent with the 2012 Report. In email correspondence on December 10, 2012, EOG indicated that this recalculation process was underway but not yet complete. However, EOG's communications on this issue ceased and it did not thereafter submit amended reports or payments based upon the recalculations discussed.

In May of 2016, EOG requested permission to retroactively amend its royalty reports dating back several years. SITLA assumed this was to correct amounts owing consistent with the 2012 Report and the previously agreed-upon unbundling methodology. The amended reports, however, only claimed additional deductions for processing costs, and did not make necessary corrections concerning disallowed gathering and/or marketable condition costs.

The 2018 Audit Report.

As of the end of 2017, EOG had neither paid the amounts owing the Trust under the 2012 Audit, nor implemented the previously agreed-upon changes to their method of calculating royalties. As a consequence, SITLA informed EOG in January of 2018 that it was commencing an audit of the 2013 through 2017 calendar years. This culminated in an Audit Report dated April 23, 2018 (the "2018 Report") (attached to the Petition as Exhibit A). The 2018 Report noted five separate royalty payment issues. The most consequential of these issues relates to EOG's deduction as costs of "transportation" amounts that the federal regulations define as non-deductible marketable-condition costs. The 2018 Report also noted EOG's having exceeded certain caps for the maximum amount that may be claimed as transportation costs, and processing deductions, among other issues.

The 2018 Report noted that due to the complex methodology EOG uses to calculate royalties, and the absence of certain necessary information, the precise amount of unpaid royalties was difficult to calculate. The report concluded that the best estimate of EOG's unpaid royalty balance (including amounts dating back to the 2012 Report) stood at $2,200,000. The report stated that SITLA was willing to discuss how it arrived at this number with EOG and invited EOG to submit relevant evidence and schedule a meeting. Unfortunately, EOG has not engaged with SITLA to have that discussion.

The present appeal.

On August 22, 2018, EOG filed its Petition, requesting that the Board either reverse SITLA's audit finding and order that a $743,000 refund be paid to EOG, or remand the matter to SITLA for further analysis. EOG also requests a settlement conference at which the parties might clarify the outstanding issues and attempt to resolve the matter.[2]

THE EFFECT OF MISSING INFORMATION ON THE AUDIT FINDINGS AND ON THESE PROCEEDINGS

As partially summarized in the Background section above, SITLA encountered significant difficulties in determining the precise dollar amounts associated with the identified errors in EOG's royalty calculations due to a lack of access to certain information in the possession of EOG. This lack of critical information forced SITLA to make certain assumptions, and utilize proxy unbundling methodologies, in completing the audit findings. The Petition criticizes SITLA for

[2] SITLA shares EOG's desire to narrow and clarify the issues, and potentially resolve some or all of matters in dispute, via negotiation, whether through direct discussions with EOG or via participation in formal Board-ordered settlement conferences pursuant to Utah Admin. Code R850-8-700.

using numbers, or formulas, that do not specifically apply to the subject wells and field. In those instances where this is true, it is the consequence of EOG's failure to provide SITLA with necessary information. SITLA was forced to use the best available substitute information instead. The most significant pieces of information that SITLA was not provided include the unbundling cost allocation, the 2013 through 2015 royalty calculation spreadsheets, and schematics detailing where measurement points and compressors are located and costs are incurred.

STANDARD OF REVIEW

Under Utah Code Ann. § 53C-1-304(4)(a), "the board shall uphold the decision of the director or the administration unless it finds, by a preponderance of the evidence, that the decision violated applicable law, policy, or rules."

RESPONSE TO EOG'S PETITION

The following paragraphs respond to the individual sections set forth in the Petition's Procedural History and Argument discussions.

Audit History and Findings.

EOG's claim that SITLA's "entire audit findings rely on an extrapolation of sample months from the audit period" mischaracterizes the 2018 Report. Although some amounts have been extrapolated, the findings in the 2018 Report are based upon the information provided by EOG, including all of the Contract 476PI transportation invoices. Due to the lack of information provided as detailed above and, as noted in the 2018 Report, the complex methodology used by EOG, SITLA's calculation of royalties owed necessarily represents an informed estimate.

The "Federal Floor" lease provision.

As noted above, SITLA's lease form establishes as a floor the price the federal government receives under its regulations for royalty valuation purposes. This practice is consistent with the ruling of the Utah Supreme Court in *Enron Oil & Gas Company v. Utah Div. of State Lands and Forestry*, 871 P.2d 508, 511 (Utah 1994). In its Petition, EOG relies on the dissenting opinion in *Enron* to make the argument that federal royalty valuation does not apply to state leases. However, as will be discussed in greater depth in later briefing, the language of the oil and gas leases and majority decision of the Supreme Court in *Enron* require that all elements of royalty valuation be the same for state leases as for federal leases where any deviation would result in lesser valuation and payments to SITLA.

Although EOG asserts the federal valuation regulations do not apply, it has not specified what rules it believes govern royalty valuation, deduction and payment issues in this matter. Nor has EOG explained whether the royalty valuation practices disputed by SITLA (including EOG's double-deductions discussed below) comply with those rules. In any event, SITLA contends that to disregard the federal regulations, and rely instead only on the lease provisions, would likely result in a finding of an equivalent or larger underpayment of royalties.

The Ryan, LLC response letter.

Following SITLA's granting of certain extensions for response, EOG, through its consultant Ryan, LLC, submitted a July 13, 2018 letter ("Ryan Letter") responding to the 2018 Report. The issues addressed in the Ryan Letter are largely repeated in EOG's Petition, and are addressed in the individual sections below.

One particular position taken in the Ryan letter and in the Petition—that EOG is owed a $743,000 refund—is addressed here. Among other reasons to be addressed in later briefing, EOG's refund claim should be denied in its entirety due to the following.

First, unlike SITLA's longstanding demands for payment of royalty shortfalls, EOG asserted this overpayment argument for the very first time in the Ryan letter in July of 2018, after the 2018 Report was completed. EOG has not identified the calendar years to which this refund claim applies, but to the extent the claim reaches back to the inception of the periods at issue in the SITLA audit, EOG's claims may be subject to applicable statutes of limitation (including Utah Code Ann. § 78B-2-309).

Second, EOG's refund claim, and the present assertion of that claim within the context of this appeal, are barred by the provisions of the Governmental Immunity Act of Utah, Utah Code §§ 63G-7-101 et seq.

Third, SITLA disagrees that EOG, having calculated and voluntarily chosen to pay the subject royalty amounts, is entitled to seek a refund at this stage. Under the voluntary payment rule, "where money has been paid voluntarily with full knowledge of the facts, it cannot be recovered." *Freston v. Gulf Oil Company*, 565 P.2d 787, 789 (Utah 1977) (discussing *Thurman v. Clark*, 507 P.2d 142 (Wyo. 1973)). *See also*, *QEP Energy Company v. Sullivan*, 2010 WL 11468559 at *6 (D. Utah 2010). EOG has not provided any explanation as to the circumstances regarding why certain charges were not deducted or why the voluntary payment rule wouldn't bar its $743,000 claim.

Fourth, EOG has provided no explanation or back-up documentation disclosing how it arrived at the $743,000 figure, and the Board, if it reaches this issue, should reject this claim based on this failure of proof. SITLA denies that any overpayment was made by EOG.

Finally, EOG's refund claims are barred by the doctrines of laches, estoppel and unclean hands.

Misapplication of ONRR regulations and guidance.

EOG asserts in this section, with little elaboration, that SITLA has misread the applicable ONRR regulations. One of EOG's primary criticisms appears to be that SITLA in written correspondence provided outdated citations to ONRR regulations, referencing, for example, 30 CFR § 206, when that regulation has since been redesignated as 30 CFR § 1206. This redesignation, however, has no substantive effect on the outcome of the audit or findings in the Audit Report. Additionally, SITLA notes that the correct citation to the regulations was given in the 2018 Report.

Royalty measurement point error and gathering charges.

Although it appears from EOG's petition that the royalty measurement point (sometimes referred to as facility measurement point) for some of the wells in question is located on the well pad within the applicable oil and gas lease, this information was not provided to SITLA until certain "sample site security schematics" were included in the Petition, long *after* the Audit Report was issued.

SITLA's audit and Audit Report used the tailgate of the processing plant as the royalty measurement point based upon the information (or lack thereof) provided by EOG during the audit, and was part of an attempt by SITLA to come up with an amicable resolution to the issue. It should be noted that EOG's suggested use of an upstream measurement point would both subtract from, and add to, the audit finding. Although SITLA's Audit Report disallowed certain transportation expenses because of the assumed royalty measurement point, certain processing expenses that would have been disallowed under EOG's newly-offered evidence were not accounted for in the audit determination.

Additionally, EOG's argument that "not all compression, dehydration, or treatment is performed to make gas marketable" (Petition Paragraph 29 at Page 9), while true as a general statement, leaves out a critical element of the analysis discussed in *Burlington Resources Oil & Gas Co. v. Office of Natural Resource Revenue*, 183 IBLA 333. In *Burlington*, the Interior Board of Land Appeals determined that a transportation allowance may be taken "'only if such services are required for transportation and exceed the services necessary to place production into marketable condition,' as required by 30 CFR §206.152(i). 30 CFR §206.157(f)." EOG relies on the general statement of the rule without demonstrating, or even meaningfully analyzing, it applicability here. This would require a showing that the products meet the definition of "marketable condition" found in 30 CFR § 1206.151 and that the deductions are necessary for transportation. As will be shown at hearing, the evidence does not support this conclusion.

Lack of a reasonable proxy.

As stated in SITLA's August 8, 2018 correspondence, using the Manzanares system as a proxy for the Chapita plant was reasonable at the time due to the failure of EOG to provide SITLA with any unbundling analysis. As further pointed out in that correspondence, since the issuance of the 2018 Report, an unbundling cost allocation formula has been developed specifically for the Chapita plant by ONRR. Based on SITLA's analysis, the audit findings in this case would only increase based upon this new ONRR unbundling cost allocation information.

Transportation subject to cap.

As EOG correctly notes, 30 CFR § 1206.109(c)(2) provides for a mechanism to *apply for* an exception to the fifty percent (50%) transportation allowance limit found in 30 CFR § 1206.109(c)(1). EOG, however, has provided no evidence to SITLA that it has applied for such relief. Therefore, the fifty percent (50%) limit has not been waived by ONRR (or SITLA) and cannot be exceeded. Additionally, EOG states that its "transportation costs were reasonable, actual, and necessary." EOG is not the decider of those facts; ONRR (or SITLA) would make that determination if and when an application for exception was submitted. To SITLA's knowledge, this has not occurred.

Processing subject to cap.

The issue of processing costs being subject to a cap presents a similar problem. Although as EOG notes there is a mechanism set forth in 30 CFR § 1206.158(c)(3) to apply for an exception to the general rule limiting processing allowances to sixty six and two thirds percent (66 2/3%), EOG has provided no evidence to SITLA that it has requested (or received approval for) such excess allowance. Even if such processing costs were "reasonable, actual, and necessary" as EOG claims, those facts are for ONRR (or SITLA) to decide, not EOG. Additionally, Section 4(b) of the SITLA oil and gas leases provides additional, independent authority for the limit of processing costs and state that the "deduction for such costs may not exceed two-thirds of the amount of the gross of any such products…"

Fuel charges

Based upon the information reviewed in the audit, EOG is double charging SITLA for fuel used both upstream and downstream of the Ironhorse/Stagecoach plant. EOG's gross proceeds are determined by the volume of gas delivered to sales points downstream of both the plant and the point of receipt into Questar's main transportation pipeline. EOG has already taken an allowance for fuel used by basing its royalty payments on the lower volumes at the sales points. By converting fuel used in the field and fuel used along the Questar transportation line into a monetary deduction from gross proceeds, EOG takes this deduction twice. EOG is both using the fuel without paying royalties on it, and taking a deduction for the value of such fuel.

Statute of limitations.

EOG cites two statutes of limitation (or repose) it contends bar a portion of SITLA's claims. EOG offers little or no explanatory argument in support of this suggestion (SITLA assumes this will be briefed and argued after a hearing examiner is appointed and a briefing schedule is set). SITLA will fully address these issues at that time, but briefly offers the following.

First, the Utah Supreme Court has determined that when the State of Utah brings an action for royalties derived from trust lands, the six year statute of limitations in section 78B-2-309 (cited by EOG) does not apply. *Trail Mountain Coal Company v. Utah Division of State Lands and Forestry*, 921 P.2d 1365 (UT 1996).

Second, while Section 78B-2-201 (also cited by EOG) applies to the State of Utah, it does not apply to administrative proceedings. This statute only bars the state from bringing an "action" with respect to any real property, including for royalties, based on the state's title to that property. An "action" is defined by statute as a "civil action[ ] in which affirmative relief is sought." Utah Code Ann. § 78B-2-101. A "civil action" is initiated by filing a complaint with the court. See Utah R. Civ. P. 3(a); *Phillips v. Department of Commerce, Division of Securities*, 2017 UT App 84, ¶¶ 12-15. The Utah Supreme Court recently held that "an administrative hearing is not a civil action" for purposes of the statute of limitations in Title 78B. *Phillips*, 2017 UT at ¶ 14-15. *See also, Morgan v. Department of Commerce, Division of Securities*, 2017 UT App 225, ¶8.

Even if Section 78B-2-201 applied in this case, under a 2015 amendment, the statute is triggered only when the state receives actual notice of the facts giving rise to the action. SITLA did not have notice of EOG's erroneous royalty calculations until SITLA conducted an audit and issued its first findings in 2012, which is within the seven year limitations period.

Any delay on the part of SITLA in making its final determination is attributable to EOG's failure to provide SITLA with timely information when requested and the understanding that EOG was working toward implementing the methodology from the 2012 audit report. SITLA has been patient in giving EOG sufficient time to modify, amend and correct its past royalty reports only to find in performing the 2018 audit that EOG has not implemented certain changes previously discussed.

For these and other reasons to be briefed before the hearing examiner, SITLA denies that any portion of its claims are time-barred.

Working interest partners.

EOG has not addressed issue No. 5 in the Audit Report regarding whether other operators were taking their respective production in-kind and whether EOG is paying to SITLA one hundred percent (100%) of the royalties due to SITLA under the lease. That issue remains outstanding.

CONCLUSION

It was only after the 2018 Audit Report that EOG, through Ryan, informed SITLA that it was seeking a $743,000 refund for overpaid royalties. Neither Ryan (through the Ryan Letter) nor EOG (through the Petition) has provided any evidence or back-up documentation showing how this figure was determined. SITLA denies the alleged overpayment occurred and is unable to fully comment or brief the issue until further information is provided by EOG regarding the basis of its calculations.

The information obtained since the 2018 Audit Report (regarding the unbundling of the Chapita plant, among other matters) support SITLA's position as reflected in the 2018 Report and would only lead to a larger audit finding. As stated in the Audit Report and the August 8, 2018 correspondence to EOG, SITLA requests a meeting with EOG to discuss and negotiate the outstanding audit issues.

As noted above, the scope of this response is limited to identifying issues that are in dispute to help frame the controversy. SITLA denies any allegations or assertions contained in the Petition that are not specifically admitted herein. SITLA will address the issues in dispute in greater depth through the presentation of evidence, and further briefing and argument, once a hearing examiner is appointed and a briefing schedule is set.

Respectfully submitted this 31st day of October, 2018.

SEAN D. REYES
UTAH ATTORNEY GENERAL

_/s/ Michael S. Johnson______
Michael S. Johnson
Christopher Shiraldi
Special Assistant Attorneys General
Attorneys for Respondent Utah School and Institutional Trust Lands Administration

CERTIFICATE OF SERVICE

I hereby certify that on October 31, 2018 I caused a copy of the foregoing RESPONSE to be served via email upon:

Shawn T. Welch (7113)
Chelsea J. Davis (16436)
HOLLAND & HART LLP
222 South Main Street, Suite 2200
Salt Lake City, Utah 84101
stwelch@hollandhart.com
cjdavis@hollandhart.com

Mark E. Burns
Highways & Utilities Division Director
Utah Attorney General's Office
160 East 300 South, 5th Floor
Salt Lake City, Utah 84111
markburns@agutah.gov

___/s/ Michael S. Johnson___________